



CONSUMER MARKETS

# IFRS and Retail

KPMG INTERNATIONAL



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## Executive Summary



This report examines in detail how a small sample of retail groups in three continents have applied IFRS, and whether the conversion has succeeded in terms of the stated aims of the transition to the new standards. The report is based on lengthy discursive interviews with nine retail groups which have extensive operations that embrace both core and non-core retail activities.

**Companies were asked questions in three main areas of concern. How much remains to be done in IFRS implementation in the retail company sector? How much further refinement of IFRS or implementation guidelines remains to be achieved? What are the remaining challenges in using IFRS implementation in communication with shareholders and wider financial markets?**

- A small number of **implementation challenges** are repeatedly cited as important, irrespective of the nature or location of the retail business. These include implementation of the component approach to accounting, revenue recognition, and accounting for leases. A wider range of issues is identified by fewer companies - these include foreign exchange issues, impairment of assets, pensions, inventory, and accounting for goodwill. Several companies also identify lack of expertise among professional advisers as something that augmented the implementation challenge.
- Companies consider that more **guidance** is required, and some companies consider that **disclosure** requirements are too voluminous (although this is an area of disagreement). In terms of specific revisions, companies suggest that IFRS requires improved precision in several areas: most commonly cited is impairment of assets.
- Many companies express either no intention or very modest intentions to **lobby for changes to IFRS**. There is no consensus on the best method of lobbying. European retailers are evenly divided between preferences for individual approaches to the IASB and collective or third-party approaches. European companies appear to agree that the effectiveness of lobbying so far has been limited, yet many believe that it remains worthwhile.

Eight out of nine companies believe there will be long-term benefits from better harmonization of accounts across borders

- Many companies say that the effect of IFRS on **operational decisions** will be marginal, but only one out of nine companies say that there will be no effect at all. Seven out of nine companies say that IFRS will change the way they handle leases. Two companies consider that IFRS will affect decisions on store viability.
- Companies express a large measure of consensus that IFRS has improved the **comparability** of accounts; the only exception was due to one case of special national circumstances. Few companies express a strong view on the impact on **transparency**. There is a large measure of consensus that IFRS has impaired the **legibility** of accounts.
- The majority of companies agree that the level of **financial community understanding of IFRS** is poor but improving. Commenting on the ability of both banks and investment analysts to interpret IFRS, one company says that the transition to new standards will increase expectations that auditors would fully interpret accounts. Only one company considers that shareholder understanding of IFRS is good. The great majority of companies believe that companies and their auditors need to do more to improve understanding in the financial community and among shareholders.
- Eight out of nine companies believe there will be **long-term benefits** from better harmonization of accounts across borders. Several companies comment that IFRS will improve communication and the mobility of staff within a network of subsidiaries. Companies also consider that IFRS will improve acquisition opportunities. Two companies add that there will be benefits from improved access to capital markets. However, two companies also caution that IFRS benefits may take longer than expected to materialize.

## Introduction and Overview

The introduction of International Financial Reporting Standards (IFRS) in Europe and beyond has proved to be one of the most controversial issues that corporate finance officers have grappled with in many years. There is controversy over IFRS as a public policy issue, as the new standards have become items of contention between political and professional bodies in Europe. There is controversy over the transition to IFRS, as companies have struggled with the workload of converting their financial reporting to complex and in some cases opaque IFRS norms. And there is controversy over the very utility of IFRS, with many European companies questioning the validity of IFRS as a means of presenting true and fair accounts of the health of businesses. Controversy is also likely to continue, as IFRS is both refined and extended in jurisdictions beyond Europe. As many companies are now well aware, the new reporting standards contain numerous options in terms of data sets and presentation styles. The purpose of the present report is to examine in detail how a small sample of retail groups in three continents have applied IFRS, and whether the conversion has succeeded in terms of the stated aims of the transition to the new standards.

This report is based on lengthy discursive one-to-one interviews conducted by KPMG partners in late 2005 and early 2006 with nine retail groups which have extensive operations that embrace both core and non-core retail activities. The participating retailers have annual sales that range from €500 million to in excess of €50 billion. Each participant was one of the top ten retailers in their market. They include seven large European groups. Other contributing companies include one of the largest retail groups in Australia and a large retail group in South Africa. All but three of the retailers are listed companies (two of the three unlisted companies elected for early adoption of IFRS, and the third prepared an IFRS statement as a reporting exercise).

These retailers discussed a wide range of issues raised by the transition to IFRS. But in particular, they were asked to consider three main themes:

- **How much remains to be done in IFRS implementation in the large retail company sector?** How much outstanding work relates to organizational development designed to extract maximum advantage from IFRS-related opportunities? How much outstanding work relates to developing relationships with external partners – regulators, financial analysts, and shareholders?



- **How much further refinement of IFRS or implementation guidelines remains to be achieved?** In particular, have large retail groups adopted effective communication and lobbying processes as IFRS undergoes continuing reformulation? Is this communication and lobbying best achieved on a company basis, or on a collective basis such as through the use of national or international industry federations or informal cross-company collaborations? Who are the key lobbying partners for retail companies?
- **What are the remaining challenges in using IFRS implementation in communication with shareholders and wider financial markets?** What is the impact of IFRS on the relationship between retail companies and professional financial intermediaries? Does IFRS affect the relationship between retail companies and actual shareholders?

Financial accounts written under IFRS have been mandatory for European listed companies reporting on or after January 1, 2005, but the impact of IFRS conversion can be felt beyond Europe, and beyond the listed sector. Unlisted companies in Europe can also draw up their consolidated accounts in accordance with IFRS for financial years starting on January 1, 2005 or later (and one such unlisted European company participated in the interviews). By the end of 2006, several thousands of listed and unlisted companies in Australia will have switched to IFRS, and from 2009, companies listed in the United States that publish accounts in accordance with IFRS will no longer be required to bring accounts into line with U.S. standards.

IFRS are already the most widely used accounting standards worldwide. They are now used in more than 90 countries across Europe, the former Soviet Union, Africa, the Middle East and Australasia, and are being adopted by an increasing number of companies in China, Japan, and Canada.

## The Competitive Setting

The results suggest that the transition to IFRS and the benefits that retailers expect to derive from IFRS are quite peripheral to their main business priorities.

As part of the research for this report companies were asked to identify the leading non-financial challenges they face. Their responses paint a picture of the competitive setting in which they have accomplished the transition to IFRS, and also the relevance of IFRS to their wider business concerns.

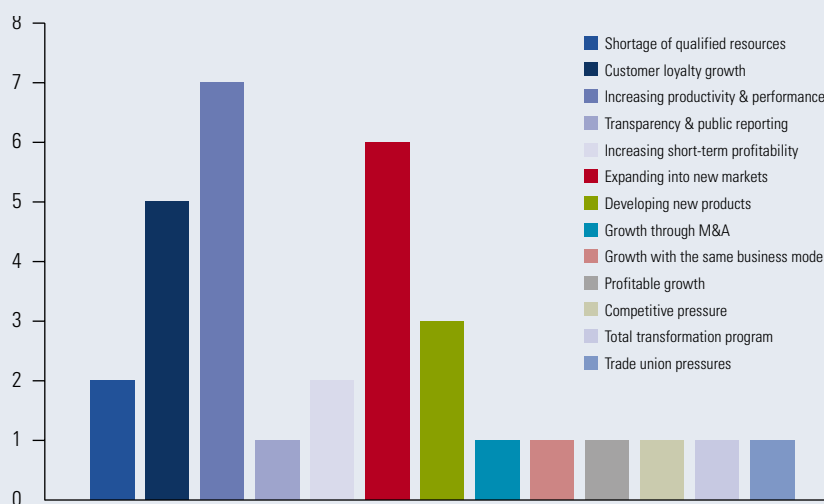
Perhaps surprisingly, the results suggest that the transition to IFRS and the benefits that retailers expect to derive from IFRS are quite peripheral to their main business priorities. Companies were offered a list of possible areas to select as key non-financial challenges, and also offered the option of identifying additional concerns.

Only one of the samples of companies selected any of the five suggested areas of concern that are most closely allied to the process of financial reporting. No company considers that long-term financial health of the company is a key issue; neither are risk management issues, the need to ensure trust from shareholders, or overall corporate governance selected by any of the sample as leading issues. Only one company believes that transparency and public reporting is a key issue for the company.

On the other hand seven out of the sample of nine companies consider that increasing productivity and performance is a key issue. Next in importance is expansion into new markets (five companies), with customer loyalty growth (five companies) and development of new products (three companies) also of importance. Also, three companies identify sales growth as a leading issue, albeit each with a slightly different focus: only one company identifies growth through M&A as important, while one company comments that it considers that organic growth is of increasing importance compared to M&A growth.

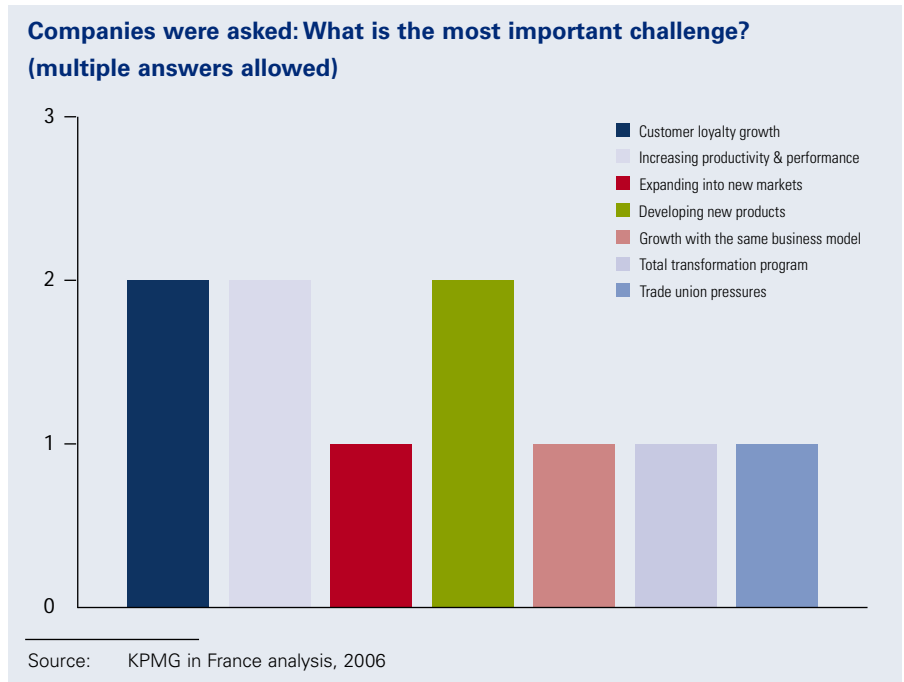
In other words, retailers are almost unanimous in their focus on growth and return, and their confidence in the current quality of their communication with financial markets and shareholders. That could be because they feel they have achieved better quality of financial communication through the transition to IFRS, that interpretation appears unlikely given the widespread reservations expressed about the value of IFRS as a communication tool, and the widely expressed hope that IFRS will evolve and improve through the implementation process.

**Companies were asked: What are the three biggest non-financial challenges facing your company? (Companies' own categories allowed)**



Source: KPMG in France analysis, 2006

Companies were also asked: What is the most important of these challenges? Companies could select more than one if they felt that several challenges ranked equal first in importance. Increasing productivity and performance, development of new products, and customer loyalty growth were selected by two companies; the other leading issues in the broader questionnaire (expansion into new markets and sales growth) were selected by one company each. The remaining two selections reflect specific circumstances. The Australian retailer in the sample selected its own total business process transformation program as its most important challenge; the South African retailer selected trade union pressure as the most important challenge.



For this report nine large retailers were interviewed at length in face-to-face interviews in their own offices by KPMG firms' professionals. Although based on a questionnaire, the interviews were discursive. Companies were encouraged to raise new issues they considered of concern, and supplementary questions were asked. The interviewees were either one or two finance directors or CFOs.

### **Companies were asked: What are the biggest challenges retailers face in implementing IFRS?**

In interviews it was notable that a small number of issues are repeatedly cited as important, irrespective of the nature or location of the retail business. These include implementation of the component approach to accounting for property, plant and equipment, revenue recognition, and accounting for leases. A wider range of issues was identified by fewer companies - the issues include foreign exchange impairment of assets, pensions, inventory, and accounting for goodwill. Several companies also identify lack of expertise among professional advisers as something that augments the challenge.

## The treatment of leases under IFRS is identified as a leading implementation challenge by five out of nine companies

It is also notable some issues arose from the diversified nature of many large retail businesses: companies frequently find that what works well for one subsidiary may not work in the same way for another.

- **Leases:** the treatment of leases under IFRS is identified as a leading implementation challenge by five out of nine companies. A problematic area is the treatment of stepped rental increases as having equal impact in all years of the life of the lease (that is, all rents are added together and then divided into equal increments for each year of the lease, irrespective of the cash impact of the increments in any given year). “You get a bizarre outcome if you just take a simple average of rental steps and divide them,” says the Australian retailer. “For one thing it is inconsistent because it doesn’t apply to leases that are CPI-linked or mark-to-market every few years.” The Australian retailer gives a further example of the inconsistent result of ‘straight lining’ rental increases in accounts: “We have two brands that were affected differently,” says the company. “The first was where they have leases with a substantial dollar increment, the effect is to benefit the accounts because they are more than halfway through the term of the lease. On the other hand our other chains, which were only set up two years ago, have got a fixed lease at 2.75 percent per annum increase in rental, and because they are all at the early part of the lease, they get penalized and the profitability under IFRS in that business will halve as a result of that. So we have to say to the management of this chain, you have a business that will look great in the accounts in 2012 but unfortunately does not look good now.” A U.K. retailer also considers lease treatment to be an anomaly, and considers that as a result the company will have to hedge the rental increases. This issue is also cited by a South African retailer. In addition, two European retailers cite the assessment of operating leases versus finance leases as a leading challenge, and one more European retailer cites the separation between land and buildings in leases, and the treatment of refurbishment expenses for leased premises, especially with regard to capitalization and amortization and depreciation policies.



- **Component accounting:** this is identified as a leading challenge by three companies. A French retailer says, “There was a huge volume of items to analyze and split into components as well as the related IT implications. This led to a lot of work.”
- **Impairment of assets:** three companies cite asset impairment as a leading challenge, with one European retailer commenting that the challenge is to set up a methodology that can be applied consistently by subsidiaries. The Australian retailer further comments on the challenges and the strain arising from the implementation of this standard: “We worked for 18 months wrestling with the cash generating units which are essentially on a store by store basis. The biggest problem was getting straight answers on how it should be done. The examples in the standard specifically show a retailer on a store by store basis, but then it became clear that some [other] retailers were clustering stores. There was also a big debate on what you include in store contributions. Since we have 2,500 stores this was a phenomenal amount of work.”
- **Revenue recognition:** two companies cite revenue recognition for vertically integrated activities as a leading challenge.
- **Inventory:** one company cites inventory valuation as a leading challenge, adding that challenges are created by cash discounts affecting the valuation of inventory.
- **Foreign exchange issues:** A U.K. retailer considers that identification of the functional currency is a leading challenge, and adds that hedging requirements of the functional currency under IAS 39 leads to a lot of work to achieve the required accounting treatment.
- **Investment property:** a French retailer considers that accounting for investment property is a leading challenge due to the organizational complexities of defining a methodology that would yield fair value that could be easily applied by all subsidiaries.
- **Goodwill:** one European company considers that accounting for goodwill is a leading challenge.
- **Options:** one European company considers that expensing share options to employees is a leading challenge.

Also, retirement of assets, documentation for closing of premises, and fair value accounting are all mentioned as leading challenges by one Spanish retailer. In addition to the implementation of the standards themselves, two companies make extensive reference to the challenge created by **lack of expertise** among finance professionals. A major food retailer in the U.K. considers that this is the biggest single challenge in implementation of IFRS: “The move from concept-based U.K. GAAP to rules-based IFRS has led to a large challenge,” says the company, adding, “There is now a much greater need to remember the significant levels of detailed requirements in each standard. It was also difficult for advisers to give concrete advice as interpretations were continually developing over the course of 2005.” The Australian retailer also feels that financial advisers with global operations prove slow to react to interpretation challenges as they struggle to create a global view.

**Companies were asked: Which standards should be amended to better reflect the economics of the retail industry? Companies were also asked: What practical consequences do you expect from the planned revision of key standards such IAS 18 (Revenue), IAS 17 (Leases), or IAS 38 (Intangibles)?**

“Complex transactions always require extensive interpretation, because the standards usually cover situations that are too general”

Companies distinguish between general principles in their attitudes to standards revisions and specific issues. In terms of general principles, one continental European retailer considers that no particular standard is in need of revision, but that more **guidance** is required in the areas it considers key challenges (such as treatment of leases). Another continental European retailer agreed that there remains a lack of precision in implementation guidance: the company says “Complex transactions always require extensive interpretation, because the standards usually cover situations that are too general.” A U.K. retailer, however, finds that guidance on leases is sufficient, but adds that there should be more guidance on ‘like for like’ sales. “These are widely reported across the retail industry but there are currently no standards or guidance on how they should be calculated.” The level of **disclosure** required gives rise to disagreements, even within single companies. One finance director at a U.K. retailer comments that disclosure requirements are already too voluminous, and that increasing them will only generate more errors on the part of companies. He says, “We are moving away from a principle-based approach, and we can no longer look at principles in order to determine the most appropriate accounting treatment.”

But another finance director at the same company counters that he feels that more extensive disclosure rules could increase confidence. “As finance director there is a benefit to me knowing that there is a rule. It assists me in sharing responsibility and culpability with the operating units and in knowing what my own responsibilities are. As long as I follow those requirements I can be satisfied that I am doing what is required.”

In terms of specific revisions, companies suggest that IFRS requires improved precision in several areas. The most cited standard is **impairment of assets**, cited as in need of revision by three companies. A major food retailer in the U.K. comments that one unintended result of the current accounting requirements is potentially to distort investment decisions. “A company may open a key store to represent a presence in a particular location and the new requirements would cause an impairment to be recognized,” says the company. “This could lead the company to take an inappropriate commercial view because of the required accounting treatment.” Also, the Australian retailer feels that the evidence of accounting approaches adopted by different companies shows strongly that asset impairment treatment is leading to anomalous accounting results. The company gives the example of another Australian retailer that reports it has no impaired assets: “We find that incomprehensible; every retail chain in the world has got stores that don’t perform. One of our brands which has a return on investment of 47 percent has impaired stores. You just can’t get every one right, and so the methodology is giving them quite a different result. So you have two essentially similar businesses and they’ve come up with very different answers.”

The standard on **leases** is also cited by two companies, including the Australian retailer which felt strongly that it should be revised. “It is bizarre and it doesn’t make any sense at all,” says the company. A South African retailer adds that it finds the leasing provisions particularly onerous given South Africa’s relatively high inflation rate. **Revenue recognition** is cited as in need of revision by two European retailers, as is **inventory valuation**; other standards cited by one company only include **public infrastructure financed by private companies**; **land use rights (the company considers that accounting for land use rights as prepaid rents and not as fixed assets does not reflect the underlying reality)**; and **cash flow statements** (this company argues that cash flow statements should be reviewed to show changes in net indebtedness as well as the net indebtedness of subsidiaries acquired and/or sold).



Companies commented on the expected consequences of standards revision against the background of the IASB Work Plan that is expected to produce amendments to the revenue and lease standards and to generate further research on intangibles. However, several companies say they are unable to comment on expected consequences of revisions as they have little knowledge of what revisions are likely to be made. A U.K. retailer adds that it thinks whatever the consequences of revisions, financial analysts will continue to look for underlying trends in business performance rather than pure accounting alterations, and will adjust results accordingly. A major food retailer in the U.K. adds that it considers that any further move towards a rules-based approach to accounting will require substantial further guidance.

Only one specific issue attracted commentary about expected consequences, which was the treatment of **leases**. Five companies in the nine-company sample expects significant consequences from alterations in the treatment of leases: one French retailer comments that if as it expected a revised IAS 17 moves to treating all leases as finance leases, that will not reflect the underlying economics of retail leasing, and will have significant impact in the accounts. A U.K. retailer believes that such an alteration will also affect business decisions, but comments that it will be advantageous in that all companies will adopt the same treatment and know their approach was consistent with other businesses.

**Companies were asked: Do you intend to influence – for example through the IASB’s ‘invitations to comment’ – the revision of those standards that strongly impact the retail sector? Companies were also asked how they planned to lobby – whether on an individual basis, or in collaboration with other companies, or through industry or professional bodies.**

Many companies express either no intention or very modest intentions to **lobby for changes** to IFRS. Three European retailers say they have no specific intentions to lobby the IAS (a major food retailer in the U.K. adding that they have not yet formed a view on whether they should lobby on specific issues); one European group says it is in the development stage of a lobbying initiative to influence the ongoing IFRS review process, and one says it continues to clarify its own position to the IASB on a range of IFRS accounting issues. A U.K. retailer says that it has already participated in a joint approach by retailers to the IASB’s International Financial Reporting Interpretations Committee (IFRIC) over concerns

## European retailers are evenly divided between preferences for individual approaches to the IASB and collective or third-party approaches

about the treatment of fixed rent increases in leases. The Australian retailer says that rather than lobbying it had commented (also on leases) to the Australian Accounting Standards Board. A South African retailer also expresses an intention to lobby.

There is no consensus on the best **method of lobbying**. European retailers are evenly divided between preferences for individual approaches to the IASB and collective or third-party approaches. One Spanish retailer suggests that lobbying at regional level is to be preferred to lobbying at the national level. One European group expresses a preference for lobbying through the company's audit partner; a South African retailer concurs, saying, "We think the audit firms should take the lead for their clients, and lobby as appropriate on issues like treatment of leases." Both U.K. retailers express a preference for lobbying in concert with other retailers. One U.K. retailer says that while there is "no perfect body" through which retailers can raise concerns, it favors continued use of informal finance director forums, adding, "These groups have decided to continue to meet and the participants have found it useful even though the majority of their transition project work is now complete. Their IFRS projects were the reasons why they were set up in the first place but it is considered that they have an ongoing benefit." A major U.K. food retailer says that if they decide to lobby on specific issues the preferred route will be through industry federations such as the British Retail Consortium.

Paradoxically, European companies appear to agree that the **effectiveness of lobbying** so far has been limited, yet most believe that it remains worthwhile. Both U.K. retailers point to what they see as the failure of the initiative by U.K. retailers to lobby IFRIC effectively on the treatment of leases: according to one retailer. "The response that was received was that IFRIC had no authority to look at this issue. It was felt by the retailers that participated that there was no clear understanding of the issue on the part of IFRIC. This certainly did scare us a bit given that we didn't have much luck with the one very significant issue that was raised." Nevertheless the company does feel that it is worthwhile to persist in lobbying. "There is no point in complaining if you don't try to change things," adds the company. One continental European retailer says that retailers would welcome more initiatives that would facilitate collective lobbying by the industry. However, the Australian retailer is sceptical of whether non-European companies could influence the evolution of IFRS, saying, "Our ability to influence is marginal; it is really the Europeans who are driving it." The Australian retailer

adds that it doubts the cost effectiveness of lobbying for change: "Since our view is that IFRS does not make a significant impact on our results, you have to ask if you want to spend your energy on fighting esoteric accounting issues. In 2005 for example IFRS put our results up by only 1 percent. Even in a more volatile year you might only be looking at plus or minus 2 or 3 percent. So it is just not a material issue."

Seven out of nine companies say that IFRS will change the way they handle leases

#### **Does IFRS influence operational decisions?**

When asked whether IFRS will affect operational decisions in future, most companies say that the effect will be marginal, but only one out of nine companies says that there will be no effect at all.

Seven out of nine companies say that IFRS will change the way they handle leases. One continental European retailer believes that the impact will be marginal, saying that, "We will have to pay closer attention to the conditions of the lease in the light of IFRS, but that is not likely to actually prevent us leasing the asset." Other companies think the impact might be more extensive. A U.K. retailer says that the requirement for rental increases to be spread over the life of the lease is already affecting decisions about taking on new leases, while a major food retailer in the U.K. adds that all leasing decisions will henceforth have to be reviewed in the light of IFRS requirements as well as commercial requirements.

Both U.K. retailers comment that IFRS will affect decisions on store viability. A major food retailer in the U.K. comments that while there might be valid commercial reasons for opening or maintaining a non-performing store, the impairment of assets accounting treatment might undermine those reasons. The Australian retailer comments that, "When non-performing stores start to hit your P&L on an annual basis, it will at least bring a bit more focus."

Two out of nine companies comment that hedging and other financial operations will be affected: A U.K. retailer comments that hedging in particular now has to be considered in the light of what the company considers the IFRS requirement for significant additional resources to achieve the prescribed accounting treatment.

“This will actually make us focus on the question, are these things really worth doing?”

One company comments that IFRS requirements on **revenue recognition** might affect operations, particularly in the case of certain reserved sales or ‘lay by’ sales. The Australian retailer considers that IFRS requirements will result in deferred income from these sales. “It is not huge but it has an effect,” says the company. “This will actually make us focus on the question, are these things really worth doing?”

Two companies consider that IFRS requirements are likely to alter the way **supplier relationships** are conducted. One European company said that, “Although decisions may be made in the same way, the new standards have helped management to see the real nature of some partnership agreements.” Another company comments that IFRS is likely to make contracts with suppliers “more arm’s length – this has led us to having less influence in these contracts.”

In addition, one company says there will be an operational effect on **loyalty programs**; another comments that IFRS treatment of **options** may lead to smaller option allocations.

**Companies were asked: How would you describe the impact of IFRS on the legibility, transparency, and comparability of financial statements for your company and for the retail sector? In addition companies were asked to comment on the impact of IFRS on the recording and disclosure of main business issues in their financial statements.**

Companies express a large measure of consensus that IFRS has improved the **comparability** of accounts; the only exception was due to one case of special national circumstances. One large French retailer considers that IFRS has improved comparability both between companies and within a single company’s subsidiaries: it says that adopting similar standards even where different presentation options are selected has improved comparability, and added, “IFRS has improved the homogeneity of accounting rules applied in subsidiaries, especially in countries like China, Taiwan and Russia where the French accounting rules are unknown.” A private European retailer comments that even though unlisted, “IFRS rules will have a positive impact on the company as they will provide a basis for financial reports to be compared with those of companies in other countries.” A South African retailer also believes that a significant improvement in comparability has been achieved both through

“IFRS rules will have a positive impact on the company as they will provide a basis for financial reports to be compared with those of companies in other countries”

specific requirements (especially the expensing of share options) as well as through the broader international integration of accounting standards. However, a U.K. retailer questions whether gains in comparability on segmental reporting are not outweighed by difficulties in making comparisons in the P&L analysis. The Australian retailer considers that at a national level comparability has not been improved, largely because there is only one other potentially comparable retail group in Australia that has chosen significantly different presentation options.

Few companies express a strong view on the impact on **transparency**. One European retailer comments that transparency still “depends on the transparency policy of each company, as well as on the integrity and ability of directors to describe the risks and drivers of business performance.” A German retailer comments that it believes that overall transparency is improved over German GAAP (due to additional disclosures), while a major food retailer in the U.K. says that transparency has somewhat improved and points to pension scheme deficits as an example.

There is a large measure of consensus that IFRS has impaired the **legibility** of accounts. One European retailer says, “The volume of the new disclosures make accounts less legible – readers are confused by the huge amount of information disclosed in the notes.” Another says, “Financial statements are going to become very long and barely legible, full of useless information.” A U.K. retailer argues that analysts now need to work harder than before to understand the underlying performance of companies (particularly in interpreting the impact of fair value accounting on the P&L), while a major food retailer in the U.K. comments that financial markets have been so confused by the move to IFRS that many analysts are still running their U.K. GAAP models to interpret company results.

When asked whether IFRS had had an impact on the **recording and disclosure of business issues**, the majority of companies distinguish between disclosure of data and disclosure of fundamental business issues. In a typical response a major food retailer in the U.K. says that the disclosure of business issues “is more to do with the operational and financial review disclosures and not to do with the underlying accounting treatments within the main body of the accounts.” Two continental European retailers believe IFRS has improved both recording and disclosure. A major food retailer in the U.K. considers that there has been no significant impact on recording or disclosure, while another U.K.



retailer argues that the requirement to show pension deficits on the balance sheet has been a significant improvement in disclosure of the underlying impact of that item. The Australian retailer believes that there has been no significant impact on recording or disclosure, but comments that there may be marginal impact in some cases such as asset impairment. "If impairments are significant enough in any one year you would probably disclose it, while we had previously taken a whole brand approach to these things. But the issue is pretty marginal, since we already make fairly full disclosures either in the accounts or in presentation."

One Spanish retailer argues that since many retailers in Europe remain unlisted and therefore not required to apply IFRS, in many cases companies remain unaware of the potential transparency and disclosure issues raised by IFRS.

### Designing an IFRS Transition Plan

How should companies organize for transition to IFRS? KPMG firms' professionals asked the sample of large retail groups to outline their individual approaches, and comment whether in hindsight they would have acted differently.

- **French retailer:** for specific issues like impairment and leases, the company asked their auditors to help them define a methodology and provide help on interpretation. Prior to that the group financial department had set up an IFRS project structure in 2003, comprising a steering committee, a project manager and a number of task forces which were charged with:

- identification of main restatements with the help their auditors
- setting up working groups in charge of specific topics
- setting and issuing Group IFRS rules
- training of all staff concerned and presentation to general management
- adaptation of IT systems

With the benefit of hindsight, the company feels it should have used the external auditor at the initial stages. Also the company considers it should have identified and managed earlier the different options provided by FTA, which would have avoided having to change the opening balance several times.

- **French retailer:** the first stage was to clarify the nature of leases (whether operating or finance leases) working with external auditors. The second stage was to harmonize lease clauses written in different jurisdictions for different legal environments. The final stage was to identify and collate all the new information that was needed for the first annual report under IFRS.
- **Unlisted Spanish retailer:** the company went through a process of developing at group level checklists for local operations, followed by local operations raising detailed issues with the group administration.
- **U.K. retailer:** the group used external advisers from the beginning of the conversion project. Advice took longer than would normally be expected, given that there was no historical knowledge from which to draw: the group recognized that this was an unusual challenge as this was the first-time adoption and that there had been extensive work associated with many standards, particularly leases. The group found it faced a particular challenge in that they report early (with a January year-end) meaning they had to report first and therefore had to lead and not follow.
- **Major food retailer in the U.K:** the retailer says that in hindsight it would not change any of its accounting policies, but questioned whether it had, in fact, managed to identify all the possible IFRS options – if it had identified further options, it may have ended up with a different approach.
- **Australian retailer:** the retailer comments that making best use of internal resources is vital to achieve completion of the project. “The only thing I think I may have done differently is to discipline the external accountants a bit more and say ‘enough’s enough, let’s draw the line,’” says the company. “There was a tendency to say ‘let’s keep on analyzing and analyzing’. On one impairment there was a question about allocating our overheads and we had gone through endless analysis of what to do and had come to a decision. Then the auditor decided to change its mind and I got to the point where I just said, ‘No, that’s it, no more discussion to be entered into.’”



**Companies were asked to comment specifically on the ability of financial analysts, banks, rating agencies, and shareholders to understand IFRS, and to comment on how that understanding could be improved.**

Six out of the nine companies that commented on the quality of **investment analysts'** comprehension of IFRS agree that the level of understanding is poor but improving. "They are still trying to understand," says a major food retailer in the U.K., which like other companies consider that analysts' focus "has always been cash flow and will continue to be cash flow so they are not so interested in IFRS. They are likely to ignore mark to market [i.e. fair values adjustments]." Another U.K. retailer comments that analysts understand enough to extract cash flow interpretations from the IFRS accounts, but that they do not understand the underlying accounting issues. The Australian retailer agrees. "The initial feedback we've had from analysts is that they are going to ignore a lot of the IFRS adjustments and that they are still locked into an Australian GAAP way of thinking," the company says. "IFRS will take two to three years to really sink in." Similarly, a South African retailer says that local investment analysts "are only interested in earnings growth, executive remuneration and perhaps corporate governance. For example, when we announced our IFRS changes we reduced the group's net asset value by 26.5 percent, but because it did not affect earnings growth year-on-year due to the prior year adjustment, the share price was not affected at all, nor did the analysts question the reduction in net asset value."

Commenting on the ability of both **banks** and investment analysts to interpret IFRS, one continental European retailer says that the transition to new standards that are not fully understood by financial markets will increase expectations that auditors will fully interpret accounts. "The professional background of people involved in research analysis, banking, institutional investing activities and the business community is very limited in accountancy expertise," says the company. "Their focus is company valuation based on future performance, and IFRS provides little help there. So they mostly accept what management says, and they expect auditors to act as the watch-dogs."

Only one company chose to comment specifically on the quality of understanding of IFRS at **rating agencies**. A major food retailer in the U.K. considers that as in the case of investment analysts, "the impact would be limited as their focus is on cash flows."

“We need to educate and obtain buy-in from analysts and business reporters who don’t understand IFRS concepts”

Only one company, a French retailer, considers that **shareholder** understanding of IFRS is good (which the company ascribes to efforts to communicate to shareholders the significance of IFRS). A major food retailer in the U.K. considers that shareholders are likely to “become more confused” as a result of IFRS. An Australian retailer agrees. The CFO commented, “I don’t think your average retail investor has any hope of studying the P&L and the balance sheet and really understanding what the performance of a business is and really understanding the levers in the business and what makes it tick. I suspect that retail investors will be very dependent on a financial adviser or even a media report that says this is good or this is not good.”

Two continental European retailers believe that the level of expertise in interpreting IFRS in the financial community is good enough not to require specific **improvement** efforts; six companies disagreed. A U.K. retailer comments that the main onus for improvement is on companies and their accountants, but that investment analyst training is also necessary. A South African retailer agrees that companies need to educate the consumers of IFRS reports, saying, “We need to educate and obtain buy-in from analysts and business reporters who don’t understand IFRS concepts.” The Australian retailer agrees, “It is about communication,” the company says. “I think it’s just a matter of getting out there and trying to explain to the markets what the impacts are on the business. We’ve tried to do that, we’ve taken the market through what the major impacts are and what effect it has on the balance sheet and P&L. That sort of communication will be essential, certainly in the first year or two.”

Three companies also consider that while financial analysts need to work harder to comprehend IFRS and companies need to educate them, **standard setters** also bear continued responsibility to improve the understandability of IFRS. One continental European retailer says that IFRS should contain more ‘retail-specific’ guidance. A U.K. retailer comments that improvement could also come about through changes in standards, particularly in accounting for leases. A major food retailer in the U.K. also comments that in general IFRS requirements should become less complex if the level of understanding was to improve.

### The IFRS 'Do List'

In interviews KPMG firms' professionals asked companies to identify IFRS-related issues that are either ongoing projects or that may need monitoring in the future. The results form a 'do list' of outstanding issues for companies at all stages of IFRS implementation, whether it be preparation for IFRS or post-implementation refinement.

- **French retailer:** one leading current issue is impairment, which has to be assessed on a store-by-store basis. The key challenge is to overcome a lack of expertise within local management.
- **French retailer:** another important issue is monitoring of operating leases – lease contracts will remain an issue for the foreseeable future.
- **U.K. retailer:** its leading current issue is hedge accounting. Purchasing in foreign currency (i.e. currencies other than the functional currency) gives rise to ongoing challenges, especially given the large volume of transactions across the group. "The issues relate to small details buried within the individual standards that emerge as standards are applied more widely," says a finance director.
- **Major food retailer in the U.K:** its leading current issues are continuing development of group accounting manuals, which will take at least two more years; accounting for leases (particularly fixed rental payments, which are prevalent in the U.K.); and impairment which needs to be assessed on a store-by-store basis.
- **Australian retailer:** its leading current issue is impairment. (The retailer considers that impairment will represent an accounting workload, but that the methodology already developed is unlikely to be changed.)
- **South African retailer:** its leading current issues are leasing and expensing of share options, both of which have required the creation of new systems that need monitoring.

## Conclusion

The transition from national GAAP standards to the increasingly global IFRS has not been without its strains and controversies. One leading issue which is apparent from the interview responses in this report is the heavy **workload** of IFRS transition, against what some companies see as the limited benefit of IFRS.

Companies also question whether IFRS can achieve their stated aims of harmonizing accounts, improving communication with financial markets, and providing a true picture of the underlying health of businesses. Companies interviewed for this report are divided on the issue of **comparability** of accounts under IFRS: some companies point to the fact that competitors in similar markets are taking divergent approaches to accounting for what on the face of it are very similar businesses, and question whether comparability is achieved. Others take a larger view, considering that despite divergent approaches IFRS is achieving an overall improvement in cross-border comparability.

One concern is that under IFRS net asset value now has to take account of any capital gains tax

Almost all companies interviewed for this report that expressed an opinion on the ability of financial markets to understand IFRS considered that IFRS has reduced the **comprehensibility** of accounts, and that it will take a long period of adjustment before financial analysts come up to speed. Several companies comment that analysts remain interested primarily in cash flow, and since IFRS recommends the 'direct method' that does not reconcile cash flow with operating profit or net debt, it may reduce the ability of analysts to readily interpret profits claimed in the accounts (even though in practice most companies actually use the 'indirect method' where profit or loss is reconciled to total net cash flow in the operating period).

Several companies interviewed for this report also question the ability of IFRS accounts to present a **true and fair picture** of the business. For retailers, one of the most commonly cited issues relate to property. One concern is that under IFRS, net asset value now has to take account of any capital gains tax, even though CGT may not affect a retail company in a regular and recurring way: this has led several retail companies in the survey sample to identify investment property as an area of concern. The issue most frequently cited, however, is accounting for leases. Rental increases in leases have to be 'straight-lined' under IFRS, and many companies consider that this treatment does not reflect the economic reality of a company's leasehold commitments.

However, other contentious IFRS issues that have frequently been raised by companies in other sectors, such as expensing of stock options, treatment of financial derivatives, and the broad issue of whether 'fair value' or 'mark to market' accounting under IFRS introduces a false picture of volatility into annual accounts, all prove to be of little concern to the large retailers we interviewed. Only one retailer mentions options treatment (in passing), only one mentions financial derivatives, and no company argues that volatility is being introduced into their accounts.

#### What are the long-term benefits of IFRS?

Asked whether IFRS will create long-term benefits for retail companies, eight out of nine companies believed there will be long-term benefits from better harmonization of accounts across borders.

Several companies comment that IFRS will improve communications within a network of **subsidiaries**. One continental European retailer says that IFRS will 'improve reporting across the group, especially in Russia, Taiwan and China. The use of the same 'language' will improve the understanding of accounting rules.' A U.K. retailer also comments that, "There will be a long-term benefit – in particular in local and group reporting across large groups. It will also lead to enhanced transferability of people."

Companies also consider that IFRS will improve **acquisition** opportunities. "It means we will be able to look at a set of accounts prepared in a different country and be able to understand them more fully," says a U.K. retailer. "The corporate market will become more efficient over time." Two companies add that there will be benefits from improved **access to capital markets**, which will more easily be able to assess the financial position of companies seeking capital.

However, two out of nine companies also caution that IFRS benefits may take longer than expected to materialize. A Spanish retailer comments that "the main benefit will be harmonization for the whole industry, but it will take longer than expected – three to five years." A major food retailer in the U.K. also cautions that the cost benefit balance of IFRS to some companies is still unclear. "We have to believe there will be convergence benefits," says the company. "But it is a painful process, especially for businesses like ours which are not international."

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